159

City of Alexandria, Virginia

MEMORANDUM

DATE: APRIL 15, 2002

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: PHILIP SUNDERLAND, CITY MANAGER PS

SUBJECT: BUDGET MEMO # 24: HOUSING VALUES INFORMATION

While the substantial increase in housing values is something experienced in the City and the region, it is also a trend that many other cities in the United States and in other countries are experiencing. In that regard, attached you will find a recent cover story from The Economist which reports on the housing value trends. The story also discusses housing value trends and economic cycles over time.

Attachment: "The Houses that Saved the World," "Going Through the Roof," The Economist, March 30, 2002, p. 11, 59-61

Staff: Mark Jinks, Assistant City Manager

The houses that saved the world

Our new house-price survey shows that dearer homes have held the world economy aloft

IT IS somewhere to live; but a home is also, for many folk, a valuable asset. No wonder people love talking about house prices over the dinner table. In this economic recovery, however, homes have done much more than shelter people from wind and rain. They have helped to shelter the whole world economy from deep recession. The global economy now seems to be on the mend. In the first half of this year, America looks likely to grow by an annualised 4%. In Europe, too, surveys of consumer and business confidence confirm that an upturn is under way. Even in Japan, there are signs that the economy has hit bottom. The deeper downturn that many, including this newspaper, predicted after the bursting of America's economic and financial bubble and the attacks on September 11th has thankfully been avoided.

Why has the American economy held up better than expected? In part because productivity growth has been much stronger than in previous downturns. However, a more important reason has been the resilience of the consumer. Last year America's corporate sector suffered its deepest recession since the 1930s, with a massive plunge in profits and capital spending. Yet, despite rising unemployment and lower share prices, consumers continued to spend. How come? One explanation lies in the surge in house prices, where the Fed's interest-rate cuts have certainly worked their magic.

Many economists were worried last year that the wealth loss from falling share prices would force consumers to cut their spending. Even after the recent recovery, American stocks are still worth 25% less than two years ago. Yet, as falling share prices made some households feel poorer, rising house prices have made many more feel richer. Over the past year average house prices in America have risen by 9%, their fastest-ever in real terms. Although American households as a whole have more of their wealth in equities than in housing, a relatively few rich people hold the bulk of the shares. For most people, housing is by far their largest form of wealth. Two-thirds of Americans own their homes, and gains in the value of those assets have encouraged them to keep spending.

Recent studies show that in most countries changes in house prices have a bigger impact on consumer spending than do equity prices. Yet, despite their importance in the economic cycle, it is much harder to track the ups and downs of house prices across different countries than it is for stockmarkets. To help fill that gap, *The Economist* has collected data on house-price movements across 13 developed economies and will monitor these in future on a regular basis (see pages 59-61).

Our indices show that it is not only America that has been enjoying a house-price boom. In countries from Britain and Australia to France and Spain house prices have been rising at their fastest pace in real terms since the late 1980s boom. One reason, perhaps, why the German economy slumped more severely than others last year may have been its depressed housing market. Germany is the only country apart from Japan where house prices fell in real terms last year.

The boom in house prices stands in sharp contrast to previous economic downturns, when house prices typically stagnated or fell. Unlike in previous post-war cycles, this downturn was not caused by a spurt in inflation which forced central banks to raise interest rates sharply, thereby killing off a housing boom. Instead, America entered this recession with low inflation. The downturn was caused by the bursting of the high-tech bubble which had pushed share prices and investment to unsustainable levels. However, because inflation was low and falling, the Fed and other central banks were free to slash interest rates sharply to cushion demand.

Massive monetary easing by central banks has succeeded in propping up consumer spending around the world, partly by boosting house prices. To put it crudely: as one bubble burst, another started to inflate. Those capital gains have in turn been converted into cash as households have taken out bigger mortgages. In both America and Britain home-equity withdrawal (the increase in borrowing in excess of new investment in housing) has been running at record levels.

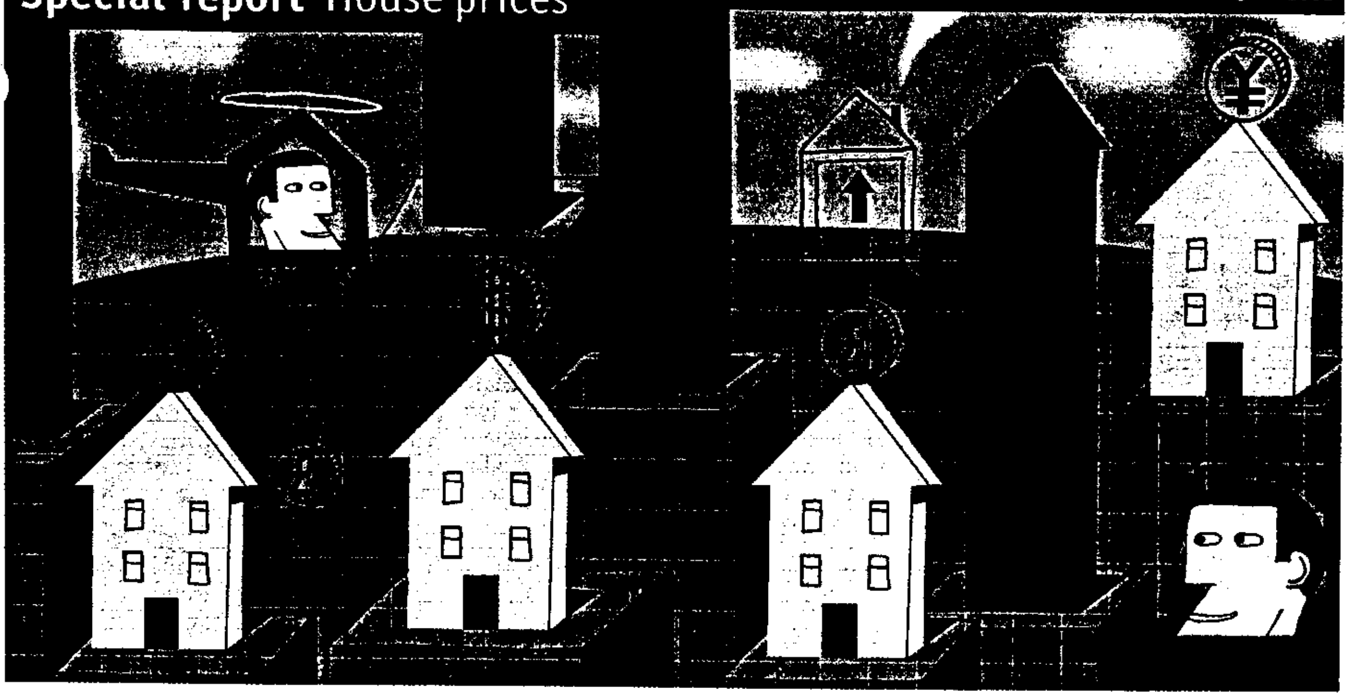
When will the music stop?

Most of the rebound in America's economy in the first half of this year will come from companies' rebuilding of their inventories. If robust growth is to be sustained, capital investment and consumer spending will need to take over. Although investment seems to have bottomed, a sharp rebound looks unlikely given weak profits, a heavy corporate-debt burden and ample excess capacity (see page 63). Once again, it is all up to the consumer.

House prices cannot continue rising at their current pace. A sudden reversal in prices would harm the recovery, but the news on that is good: a sudden reversal is unlikely unless interest rates were to rise sharply. With little evidence of increasing inflationary pressures, rates are likely to be raised slowly. If so, prices are more likely to flatten off rather than collapse. But to maintain the current pace of growth in spending, consumers will need to pile up ever bigger debts. If mortgages remain cheap in relation to income, consumers will be tempted to maintain their borrowing. But homebuyers may be underestimating the true cost of doing so. Interest rates are low only because inflation is low; real interest costs remain quite high. Initial mortgage payments are lower, but borrowers can no longer rely on inflation to erode future payments. This burden of debt could therefore squeeze future consumer spending. That need not tip America back into recession, but it does suggest a weaker recovery over the next couple of years than many expect. Mortgage refinancing has allowed consumers to maintain their spending despite rising unemployment. But such spending has literally been borrowed from the future.

The lesson which consumers—and also many over-sanguine economists—have to learn is that spending cannot outpace income for ever. House prices have saved America and the world from a deep downturn, but they do not remove the need for consumers to take care over their balance sheets. Homes are only as sound as their foundations. ■

161



Going through the roof

The Economist's new global house-price index confirms that spring is in the air. But will the housing booms in America, Britain and elsewhere end in bust?

IF THERE is one single factor that has saved the world economy from a deep recession it is the housing market.

Despite the sharp fall in share prices and a worldwide plunge in industrial production, business investment and profits, consumer spending has held up relatively well in America, Britain and several other economies, supported by low interest rates and the wealth-boosting effects of rising house prices. Over the 12 months to February average house prices in America rose by 9%, and those in Britain by 15%. Adjusting for inflation, this is the biggest real increase on record in America and the biggest in Britain since 1988.

Indeed, house prices are rising well ahead of inflation in many other developed economies. This is odd: during past economic downturns, such as the early 1980s and early 1990s, real house prices fell. The current spurt in prices is therefore causing some economists to fret that historically low interest rates are inflating a dangerous house-price bubble.

House prices do not just dominate dinner-party chatter; they also have a big influence on the economy. For most people in most countries, housing is the single biggest component of their wealth. In all the larger developed economies except Germany, more than half of all households own their home (see chart 1). Housing accounts for as much as 30-40% of total household wealth in Western Europe and almost 25% in America. Even in America, the average household has four times as much wealth in housing as in equities.

As a result, swings in property prices play an important role in the economic cycle. By boosting wealth, higher house prices encourage homeowners to spend more. They also allow owners to borrow more against the rising value of their homes. This largely explains why consumer spending held up last year as share prices tumbled. A recent study* across 14 countries found that the wealth effect of changes in property prices had at least twice as big an impact on consumer spending as did changes in share prices.

It is thus unfortunate that timely data on house prices across different countries are much harder to come by than figures on the prices of shares. To help fill this gap _The Economist_ is launching a set of global house-price indices. We have collected annual data on house prices in 13 developed economies going back to 1980, both on an average nationwide basis and in big cities. The price changes, in real and nominal terms, will be updated as new data become available, but at least once a year.

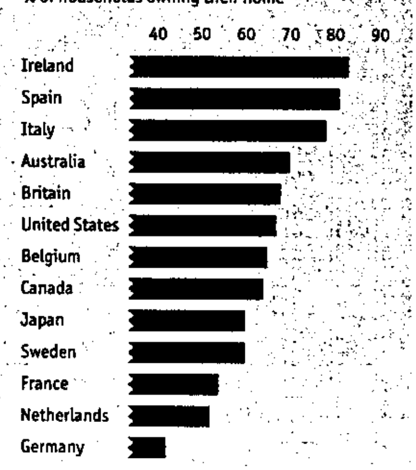
The countrywide data come largely from the Bank for International Settlements, updated where necessary using national sources. Our city data have been provided by estate agents or lending institutions in each country. The indices may not be fully comparable between countries, but they offer a broad-brush view of relative price trends.

The most striking observation from table 2 (see next page) is the huge variation in house-price inflation in different countries over the past two decades. Since 1980 Spain has seen the biggest rise in house prices in real terms, by 124%, equivalent to almost 4% a year. Britain and Ireland have also seen big gains of around 90%. Germany is the only country where house prices have fallen in real terms over the ▸▸

* "Comparing Wealth Effects: The Stockmarket versus the Housing Market" by K. Case, J. Quigley and R. Shiller. NBER working paper 8606.

Home, sweet home 1

% of households owning their home



Sources: European Mortgage Federation; IUHF; national statistics

The Economist house-price indices 2

Nationwide average

	% change 1980-2001		% change in 2001	
	Nominal	Real*	Nominal	Real*
Spain	726	[illegible]	[illegible]	[illegible]
Ireland	[illegible]	[illegible]	[illegible]	8.6
Britain	389	[illegible]	[illegible]	[illegible]
Netherlands	[illegible]	[illegible]	[illegible]	[illegible]
Belgium†	[illegible]	[illegible]	[illegible]	[illegible]
US	[illegible]	[illegible]	[illegible]	[illegible]
France	[illegible]	[illegible]	[illegible]	[illegible]
Japan	[illegible]	[illegible]	[illegible]	[illegible]
Canada	152	[illegible]	[illegible]	[illegible]
Italy‡	[illegible]	[illegible]	[illegible]	[illegible]
Australia	213	[illegible]	[illegible]	[illegible]
Sweden	[illegible]	[illegible]	[illegible]	[illegible]
Germany	[illegible]	[illegible]	[illegible]	[illegible]
Global index	148	19	[illegible]	3.2

	% change 1980-2001		% change in 2001	
	Nominal	Real*	Nominal	Real*
Dublin	767	207	14.6	9.2
Madrid	819	149	19.3	15.2
New York	356	112	11.5	8.4
London	427	103	11.2	9.3
Sydney	419	83	18.1	13.1
Brussels‡	210	58	6.7	4.1
Paris†	250	58	10.4	8.6
Stockholm	312	54	10.2	7.5
Tokyo	72	30	-5.8	-5.3
Amsterdam	103	20	6.1	1.5
Frankfurt	69	nil	1.5	-1.0
Toronto	80§	-9§	2.4	-0.1
Milan	na	na	9.8	6.8

*Adjusting for consumer-price inflation
†2001 based on Q1-Q3 data ‡Provisional §% change since 1981

past two decades, by 21%. Average real house prices in the United States have risen by a modest 20%. Since 1980 our global index (weighted by countries' GDP) has risen by one-fifth.

It is normal for house prices to rise in real terms over time. This is partly because house-price indices are generally based on the average price of properties (flats as well as houses) that have been sold. They are therefore not adjusted for improvements in the size or quality of homes over time. The average American home is today one-quarter bigger than in 1980. House prices also rise over time in line with real incomes. A country with faster growth in incomes is likely to see a bigger increase in house prices. This explains why Spain has seen the fastest house-price inflation, as its income per head has been converging with that of the rest of the EU.

American house prices have been less volatile than elsewhere (see chart 3): nominal prices have not fallen in a single year since records began. In contrast, British home prices dropped in each of the four years to 1993. House-price booms in the late 1980s in Japan and Sweden were also followed by a steep plunge in prices.

Yet average nationwide prices can conceal as much as they reveal. House prices in cities tend to be more volatile, partly because the supply of land on which to build is more limited. Since 1980 prices in New York have risen in real terms more than five times as fast as the national average. In 1983-89 nominal prices in New York rose by 137%; those nationwide by only 45%. Prices then slumped in New York, while average national prices continued to rise.

This is why we have also collected data on house-price movements in a selection of big cities. The largest increases in real terms since 1980 have been in Dublin (207%), Madrid (149%), New York (112%) and London (103%).

Over the past decade, only three countries have completely missed out on a housing boom: Canada, Germany and Japan. Tokyo's house-price bubble is still deflating: after rising in real terms at an average annual pace of 12% in the 1980s, prices have fallen for 11 consecutive years to less than half their peak in 1990.

Germany is suffering from a hangover following its unification boom. In the early 1990s the demand for housing in western Germany increased sharply as a result of immigration from the east. In 1990 and 1991 average German prices soared by one-third in real terms. A massive building boom, encouraged by tax breaks and government subsidies, then created excess supply, and prices have dropped by almost 30% in real terms since 1992. Berlin and Munich have seen much bigger declines than Frankfurt.

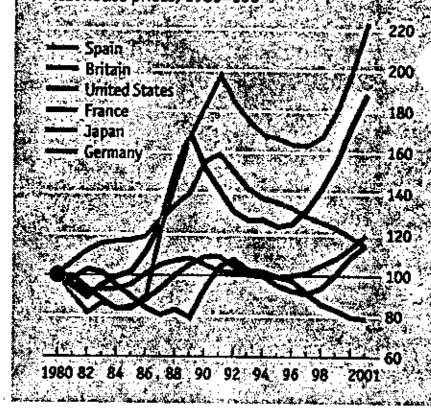
House party

Most of the world, however, has been enjoying a boom in house prices over the past few years, with prices rising at their fastest rate in real terms since the late 1980s in nine of our 13 countries. The largest real increases were in Madrid (15%) and Sydney (13%). Prices in London and New York wobbled during the fourth quarter of last year in the wake of September 11th, but are now rising again. Our overall global index gained a more modest 3% in real terms last year, thanks to another fall in prices in Germany and Japan.

These increases follow several previous years of double-digit gains in London, Dublin, Amsterdam, Stockholm and Sydney. While New York prices are rising faster than the national average, prices have been bubbling even more vigorously in some other American cities, with annual increases of over 20% until last year in San Francisco. During 2001, house-price inflation slowed in the euro area, but still managed a brisk pace (Germany apart). House prices have hotted up in the past three years in Milan and Paris after their slide in the first half of the 1990s. The surge

Booms and busts 3

Real house prices, 1980=100



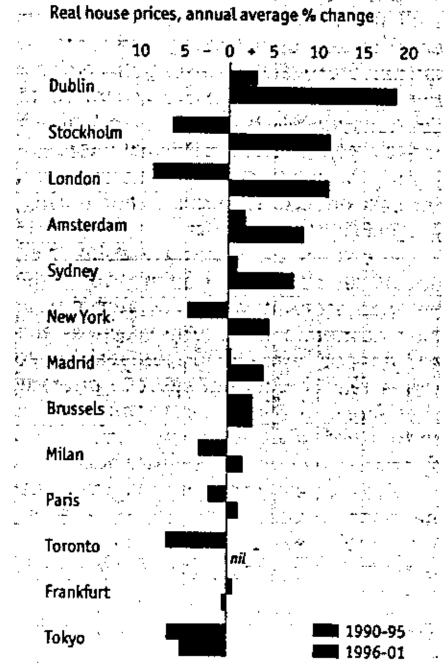
in Spanish prices last year was fuelled partly by the rush to spend pesetas earned in Spain's vast black economy before the introduction of euro notes and coins made them worthless.

Chart 4 splits the past decade into two: in most countries house prices fell or stagnated in the first half, then rose in the second. Ireland has been the world leader in house-price inflation since 1996. In real terms, prices in Dublin have increased by an annual average of 19%, thanks to a fall in interest rates ahead of joining the euro and robust economic growth. Irish owner-occupation has jumped from 74% in 1981 to 83%, the highest rate among our 13 countries. In 2000 the government introduced some tax measures to try to curb speculation and house prices started to fall in the second half of last year.

All countries' tax systems tend to fa-

Hot in the city 4

Real house prices, annual average % change



your housing over financial assets, by giving tax relief on mortgage-interest payments or on capital gains. But some are more generous than others. Britain, Australia and Canada have abolished tax relief on mortgage payments, but most European economies still offer relief, though often offset by an annual tax linked to the value of a property. Within Europe, Spain and the Netherlands offer the most generous tax relief on home purchases. Americans also get big tax breaks: interest on a mortgage up to $1m is deductible at a homebuyer's marginal income-tax rate.

Stamp duty and other transaction charges tend to be higher in many continental European countries than in America or Britain. In Belgium, transaction taxes, and legal and estate-agent (realtor) fees amount to almost one-fifth of the average purchase price. As a result, Belgians tend to move less often, and view property simply as somewhere to live rather than as a speculative investment.

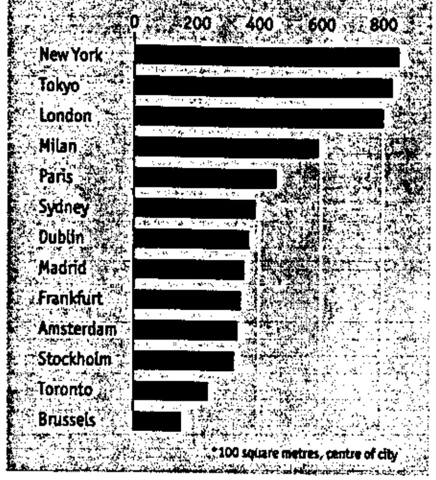
That may be one reason why property is much cheaper in Belgium. Chart 5 compares the price of a typical two-bedroom flat (100 square metres) in a smart central area in the 13 cities. New York, Tokyo and London are by far the most expensive; bargain hunters should head for Brussels. Sell your apartment in South Kensington and you could afford to buy one in each of Brussels, Stockholm and Amsterdam.

As safe as houses?

Why has house-price inflation been so robust over the past year despite a recession or at least a sharp slowdown in most economies? In the short term, the supply of housing is more or less fixed, so house prices are mainly driven by demand factors: namely, personal disposable income, real interest rates and the return offered by alternative investments such as equities.

The recent surge in house prices in many countries has largely been driven by low interest rates. In previous recessions house prices fell because the recession was brought on by central banks raising interest rates to squeeze inflation. In contrast, this downturn was caused by the bursting of an economic and financial bubble; inflation remained low. As a result, the Fed and other central banks were able to push interest rates lower than in the past, reducing the cost of a mortgage. Meanwhile, the volatility of share prices over the past couple of years has made the returns on property look more attractive, encouraging households to shift some of their money out of equities into the relative safety of bricks and mortar.

However, countries that saw big increases in house prices in the late 1980s later saw a big collapse. Could this boom also end in tears, leaving households with homes worth less than their mortgage debt? In America, Britain and several other



"For sale" 5

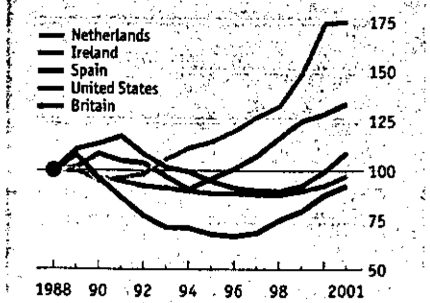
Average price of a two-bedroom flat*, $ '000

*100 square metres, centre of city

economies, mortgage debts have soared to record levels in relation to household income. Last month the IMF suggested that the rapid rise in house prices and household debt in Britain might be a potentially dangerous bubble fuelled by low interest rates. There is also some cause for concern in the United States. Dick Berner, an economist at Morgan Stanley, points out that American house prices have risen by more in real terms over the past five years than during any previous five-year period. Housing markets in Ireland, the Netherlands, Sweden and Australia have also been displaying bubble-like symptoms in recent years.

The optimists argue that there is little to worry about. With interest rates so low, homebuyers can comfortably service bigger mortgages and so support higher house prices. But lower interest rates do not necessarily justify more borrowing and higher house prices; homebuyers may be suffering from a bout of money illusion. Short-term interest rates have fallen to their lowest for 40 years in America and Britain mainly because inflation is so low. American real long-term rates are only a tad below their historical average.

Lower inflation shifts the profile of payments over the life of a mortgage. When inflation and interest rates are low, borrowers pay less in the early years, but more later on as the real value of the mortgage is eroded more slowly. But the total real cost of paying off the loan is exactly the same.



Overstretched 6

Ratio of house prices to income*, 1988=100

*Personal disposable income per head

A better measure of housing affordability is the ratio of house prices to average disposable income—the most important determinant of house prices over the medium term. The good news is that, on a nationwide basis, the house-price-to-income ratio is still below its late 1980s peak in Britain and America (see chart 6). But if prices continue to rise at their current rate, that peak will be passed within a year in America. In Spain, too, where house prices have been soaring, the ratio remains below previous peaks. In Ireland and the Netherlands, on the other hand, warning sirens should have been blaring as the ratio has hit new highs. At the other extreme, German house prices have fallen by 35% relative to income since 1980. At some time over the coming years German prices are likely to make up some of that lost ground.

However, even if the American and British markets as a whole do not appear significantly overvalued, there is mounting evidence of house-price bubbles in some big cities. In London the house-price-to-income ratio is perilously close to its 1988 peak.

Ian Morris at HSBC, a bank, calculates that the ratio of house prices to income is still well below the late 1980s peak in New York, but prices in Washington, DC, and San Francisco are approaching dangerous levels, especially for properties at the top end of the market. As Silicon Valley's fortunes have slumped, prices in that region have started to slide.

You might have expected the early 1990s house-price crash to have made homebuyers wary. Yet once again rising prices are tempting buyers to borrow up to the hilt in order to invest in a bigger home or a second property. The biggest immediate risk to the housing market would be if interest rates rose sharply, as in the early 1990s, choking off new demand. Yet with few signs that inflation is about to take off, that seems unlikely. If interest rates rise only modestly over the next year, house prices in most countries are likely to continue to rise, albeit at a slower pace, encouraging even more borrowing.

If so, when interest rates do eventually rise, house prices will be even higher and households will be burdened with even heavier debts. Our house-price index will help map this economically vital balance between debt, prices and inflation. ■

Among the many sources used in this article are: BIS, OFHEO, Japan Real Estate Institute, Nationwide Building Society, Bulwien, Compagnie des Notaires de Paris, Nomisma, ESRI, Bouwfonds, NVM, ABN-Amro, Stadim, Knight Frank, Gruppo Studio Attici, RE/MAX Excellence Realty, and PricewaterhouseCoopers.